THE USE OF FORWARD PRICING RATE AGREEMENTS

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FORWARD PRICING RATE AGREEMENTS

What is the purpose of FPRAs?

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PURPOSE

- To facilitate the estimating and negotiating of proposals, by making the process less time consuming and costly for both the contractor and government, and in the case of the latter through additional savings passed on via reduced contractor overheads and better budget forecasts.

- To establish a basis for billing rates in approving vouchers and progress payments.

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PURPOSE

- To prevent government negotiators from undermining each other’s efforts by agreeing to different rates for the same accounting periods.
- To ensure reasonable indirect rates and direct labor rates, accounting for approximately 50% or greater of all proposed costs, for government-wide use as determined by the DCMC/DCAA “team of rate experts,” rather than others less knowledgeable and experienced.

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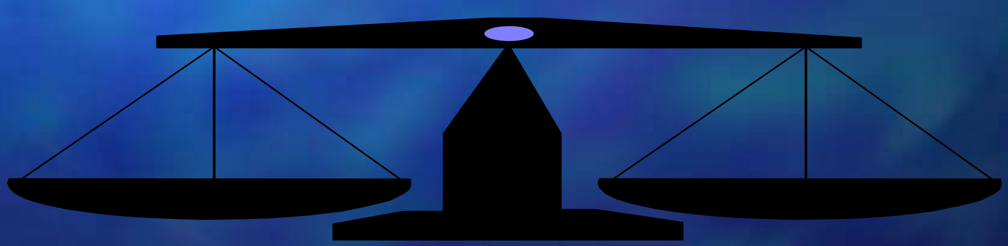
How would you characterize a beneficial segment? What factors would you consider and how might you weigh them?



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Beneficial Segments

A beneficial segment is one where there is sufficient contract or pricing volume, or the corresponding dollar value, to justify the requisite effort to establish and maintain a FPRA in terms of time, costs, and available resources. However, it is ultimately an ACO judgement as to whether a segment is declared beneficial, unless a customer specifically requests that one be established or the given location has Acquisition Category I & II programs where the government sales are equal or greater than $200 million, which solely or in tandem are in themselves determining factors. In the case of the latter, the agreement must include direct labor, overheads and G&A.

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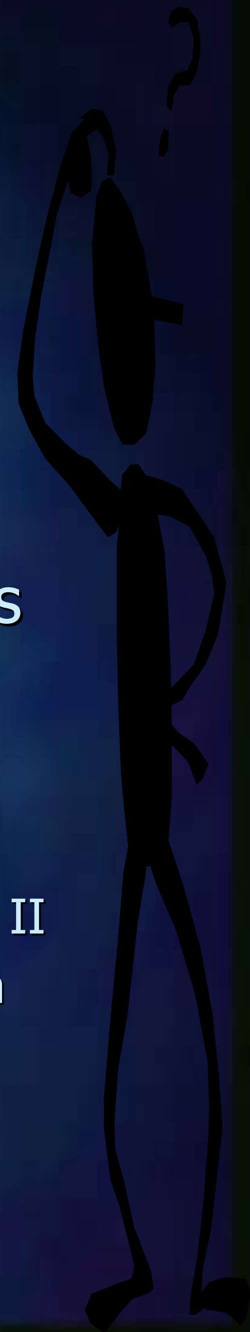
Beneficial Segments

Would you hold the following hypothetical business unit to be a beneficial segment?

- Does almost exclusively firm fixed priced work.
- The annual business base is $350M, but no contracts are ACAT I or II
- Each contract is valued in excess of $100M, but is performed over a two to three year period.
- The contractor is actively competing for new work.
- Rumors are afloat that the contractor is trying to take over another contractor and/or purchase a complementary product line.



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Beneficial Segments

While the overall dollars in themselves warrant consideration, it appears that any new awards over and above the projected business base may significantly lower the rates due to their very size. This would be further compounded by a merger or an expansion of the product lines in that it would probably increase the business base even more significantly. Additionally, a merger may invalidate the rate structure, in part or in full. Either way or in combination, it would probably result in windfall profits for the contractor under any firm fixed priced work awarded using the FPRA based upon a projected business base of $350M, unless there is a re-opener provision in each contract to cover all probable contingencies. Please note that canceling an FPRA will not recoup windfall profits under awards already made, it can only prevent further windfall profits under future awards. Accordingly, in addition to re-opener clauses, another solution may be to establish a tailored FPRA for possible small dollar value items yet to be definitized, i.e., the exercise of PIOs and repair provisions already under contract. In contrast, had the work been predominately reimbursable, caps on the rates, depending on the level of confidence in the forecasts, may afford sufficient protection, or at minimum mitigate any possible adverse effects by precluding the aggregate amount of interim overpayments.

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Tailored FPRAs

What is a tailored FPRA?

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Tailored FPRAs

A limited agreement covering a group of contracts, subcontracts, or other pricing actions, individually valued below an ACO determined dollar threshold. Usage of tailored FPRAs should be considered when a regular FPRA cannot be reached due to irreconcilable cost differences between the government and contractor, but agreement can be reached effective for a significant number of pricing actions that represent a relatively small percentage of the business base. To determine applicability and the threshold value for the individual pricing actions covered, a risk analysis should be performed.

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Contract Types

Do FPRAs apply to only cost type contracts? If not, under what contract type do we encounter our largest risk? Under reimbursable contracts, what risks are inherent with either overstating or understating the rates? Would you execute a FPRA for a contractor in an R&D environment, where he appears to have understated the rates?

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Contract Types

FPRAs apply to all the contract types in that it sets the rates prospectively for negotiation purposes in order to establish ceiling and target costs, as well as firm fixed prices and/or target prices.

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Contract Types & Risk

Some believe the greatest risk is under fixed priced contracts in that we get only one chance to set the rates accurately so as to preclude windfall profit situations. Others contend that the greatest risk is under reimbursable contracts in that improper setting of the rates can result in overrun situations, where unless the government funds the overruns, no product will be received despite all the effort and dollars expended up to the specified NTE or obligations, whichever is the lower. Conversely, where the rates are understated, it is less likely an underrun situation will be maintained, since contractors tend to budget costs and therefore processes to the dollars available, dissipating any anticipated savings due to the lower rates. However, even should that not be the case, interim billings will result in over payments for interim vouchers and progress payment requests.

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Contract Types & Understated Rates

In a cost reimbursable environment such as at an R&D house, the government would place itself in jeopardy by agreeing to rates that are set too low. First, it could result in buy-ins, since the offered costs are lower than what the expected costs actually will be. Second, it circumvents true competition since it obfuscates who the true low offeror is. Third, it makes it more likely that an overrun situation will result thereby necessitating that the program office add funding over the NTE amount, if the effort is to be completed.

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FPRAs Versus FPRRs

When would you use an FPRR over an FPRA?
Are the Buying Commands bound by each?

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FPRAs Versus FPRRs

An FPRR would be used whenever it is not feasible to establish an FPRA, including where you are unable to reach a reasonable settlement with the contractor; significant changes have been made to the accounting system, such as the business entity is undergoing a merger or restructure; and, the business base is dramatically declining or growing, etc.   Otherwise, where it has been determined that a beneficial segment exists, you should strive to have a FPRA in-place as the preferred vehicle.

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FPRAs Versus FPRRs

FAR 15.407-3(b) mandates that Contracting Officers will use FPRA rates where they exist for all contract pricing actions so that the rates are binding on all government negotiations. In contrast, recommendations are only recommendations, and Contracting Officers may either elect to accept them or not. However, reviewing authorities at the buying commands usually require explanations, including supporting rationale, as to why a negotiator disregarded those recommendations, as an integral part of the PNM.

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Adequacy of Proposals

If a contractor furnishes a wholly inadequate proposal, is it better to make no recommendations until an adequate one is furnished, or make qualified recommendations based upon all available information, even if obviously lacking? Likewise, if the contractor has proposed significant changes to the accounting system, is it appropriate to hold recommendations in abeyance until you fully understand the impact of the changes on the rates?

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Adequacy of Proposals

Because business goes on, including the need to negotiate and definitize new requirements, PCOs as well as our own DCMC personnel need recommended rates, when they need them, despite any glaring inadequacies and/or significant uncertainties. To not provide them, usually results in the government's acceptance of contractors' proposed rates, simply by default. Accordingly, contractors do not feel affronted if we refuse to accept their inadequate proposals, provided negotiations continue and they are able to sustain their proposed rates. Therefore, it is strongly suggested that despite obvious inadequacies or changes short of catastrophic, you continue to recommend rates, as requested, based upon the best available information at that time. However, the recommendations should include language qualifying them relative to the identified deficiencies and uncertainties, as well as include suggestions to employ safeguards such as re-opener provisions, as appropriate.

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Adequacy of Proposals

The best way to encourage a contractor to submit an adequate forward pricing proposal, is to impact his cash flow by decrementing the billing rates to address the uncertainties or inadequacies so as to protect the governments interests by not making premature payments under vouchers or progress billings.

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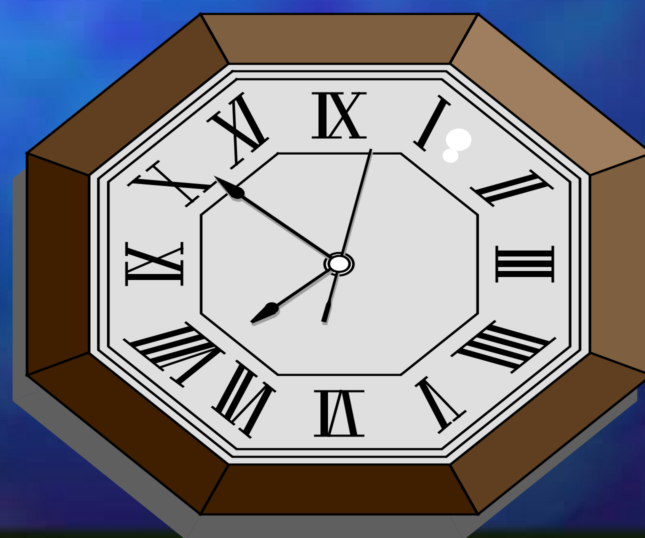
When to Effect An Agreement

Is it better to wait well into the fiscal year until we can achieve greater confidence in our numbers based upon more complete data before we consummate an agreement, or should we move forward anyway?



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When to Effect An Agreement

While there is probably nothing more accurate and reliable than projections based upon many months of actuals, negotiations should not be held pending until the price analyst has collected sufficient data to dispel most uncertainties. Accordingly, at minimum, recommendations should always be available.

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When to Effect An Agreement

Riddle: What do you call a forward pricing proposal based upon several months of actuals?

Answer: A premature incurred cost claim.

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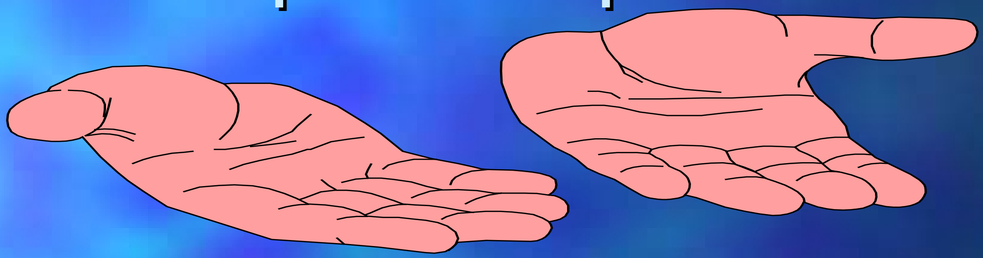
Receipt of Proposals



Ideally when should we be in receipt of a contractor's proposal? When should you begin to coordinate the effort, and with whom, germane to both the submission and review of the proposal, respectively? Besides the auditors, do you ever use other specialized technical types? Do you call the buying activities to determine the probable government business base independent of the contractor?

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Receipt of Proposals

It would be desirable to receive proposals before the beginning of the new fiscal year so that the resulting agreement or recommendations optimally are available for as much of the year as is practicable. However, this is not usually feasible, in that contractors have not closed out the prior accounting period. On the other hand, with the advent of real time rates germane to final rate claims, it is not unreasonable that contractors can provide the forward pricing rate proposal concurrent with the final rate claim. Regardless, even before receiving the proposal, you can begin to coordinate the effort by establishing a schedule, as well as responsibilities and expectations. Coordination should include the contractor, DCAA, and DCMC team members, as you deem appropriate. Team members may include the price analyst, an engineer, and other disciplines, as required. The technical types can be used to review labor hours and cost estimating relationships, as well as to evaluate the anticipated business base independent of the contractor's projections. In the case of the latter, in-house knowledge of on-going programs coupled with information solicited from the buying commands, as related to new requirements and contemplated changes to on-going programs, can be used to challenge assumptions concerning the projected business base.

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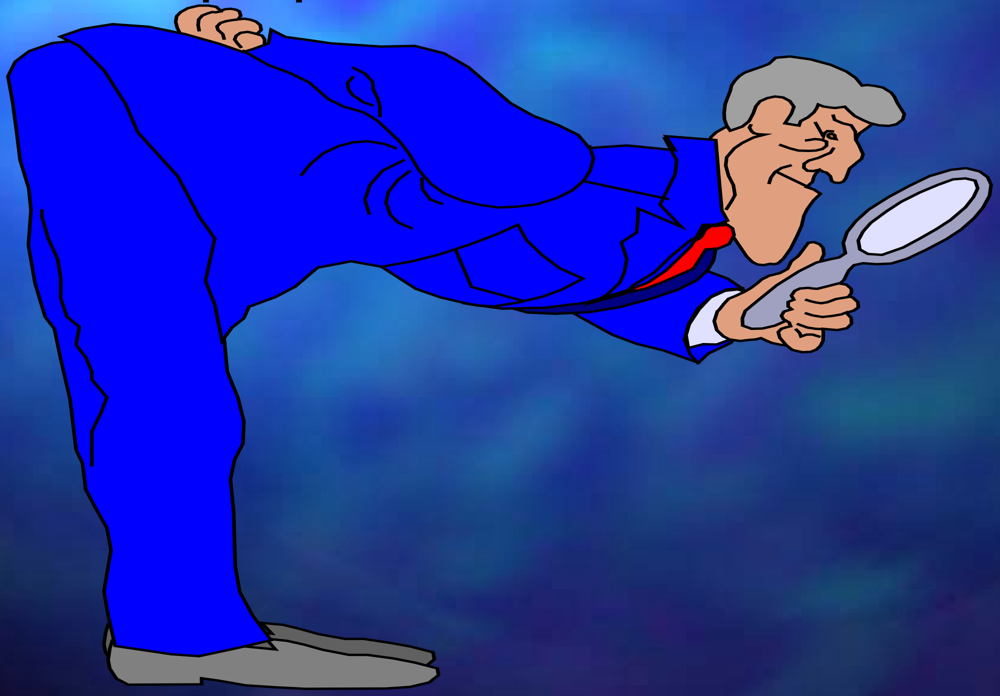
The Cost Driver

What single, underlying factor or assumption drives the entire proposal effort?



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The Cost Driver

The underlying assumption driving rate proposals is the anticipated business base or projected sales volume. All variable costs derive from that number. Additionally, it is the primary factor in making business decisions affecting the fixed and semi-variable costs, such as the need to either control or expand them, depending upon the business climate, i.e., increasing manufacturing floor space, investing in new capital assets, eliminating a layer of management.

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Incurred Costs and Trends

Should we analyze the previous years in terms of proposed versus negotiated rates versus final rates claimed? Should we analyze the historical expense pools and bases to understand the basis for any anomalies noted? What are the two most common trends that result in inflated rates?

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Incurred Costs and Trends

Most ACOs and price analysts perform trend analyses, comparing past proposals to past negotiated rates and to the final rates in order to determine a level of confidence in the current proposal, as well as to determine trends and anomalies in the estimating methodologies, as well as relationships between the costs. While such an analysis is usually performed as a matter of course, one also needs to consider if there were significant changes in personnel responsible for the new proposal, and/or if new and greater pressures are now being applied to them in order to maximize profits. More importantly, all trend analyses assume, that the basic pricing paradigm has not materially changed. Interestingly and regardless of particulars, the two most common trends that result in questioned rates, are understatement of allocation bases and over statement of the expense pools, which singly or in combination, translate into overstatement of the rates.

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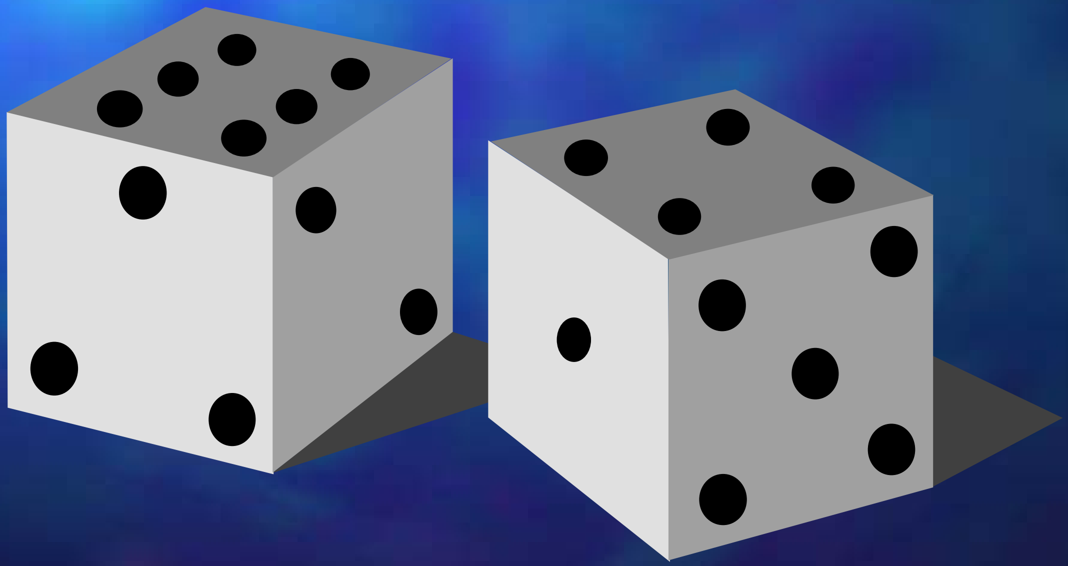
Should or Will Cost

Is it appropriate to use “should cost” and “cost realism” approaches in analyzing a contractor’s proposal?



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Should or Will Cost

In addition to trend analyses, the One Book directs us to perform risk analyses of the main drivers, based upon a "should cost " approach. However, because the estimating of rates, and in particular indirect rates, is as much an art as a science, due to reliance on assumptions and recognition of many uncertainties, a cost realism approach is also appropriate.

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PNMs

Are we required to have the pre-negotiation and post-pricing memoranda reviewed and approved? By whom and at what level? Where can we find agency policy? Does this policy apply to FPRRs as well?

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PNMs

Pursuant to FAR 15 guidelines, and more specifically the One Book, Chapter 6.2, both the pre-and-post negotiation memoranda are required for FPRAs and FPRRs. The review and approval levels are also delineated in Chapter 6.2. of the One Book, and are in consonance with requirements for other types of pricing actions.

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FPRRs

For an FPRR, do you suggest including explanations for all differences in costs between your position and the contractors, as part of your recommendations, and if so why?

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FPRRs

Yes, in fact as with FPRAs, the pricing negotiation memoranda are to be issued to all major and otherwise interested customers, so as to help ensure meaningful negotiations that are more apt to result in sustention of our recommendations. Otherwise, negotiations tend to lapse into a numbers auction, or worse, an uneven competition where government negotiators are unable to successfully counter contractors' discussion points.

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The Buying Commands

Do you involve the major buying commands to support or leverage your position? Why and how?

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The Buying Commands

Unless your main customers support your endeavors, they are in a position to undermine your efforts by ignoring your recommendations for PCO negotiations, as well as by refusing to employ available "squeeze tactics" in order to encourage the contractor's cooperation. Accordingly, it is imperative you cultivate good working relationships with your customer activities by both supporting their expressed and unstated short and long term goals and needs, in addition to pointing out the savings that will accrue from supporting your recommendations. As such, Program Management Reviews afford excellent opportunities to both solidify these relationships, and finesse program offices into notifying the contractor's management that failure to reach agreement in the future may impact future decisions.

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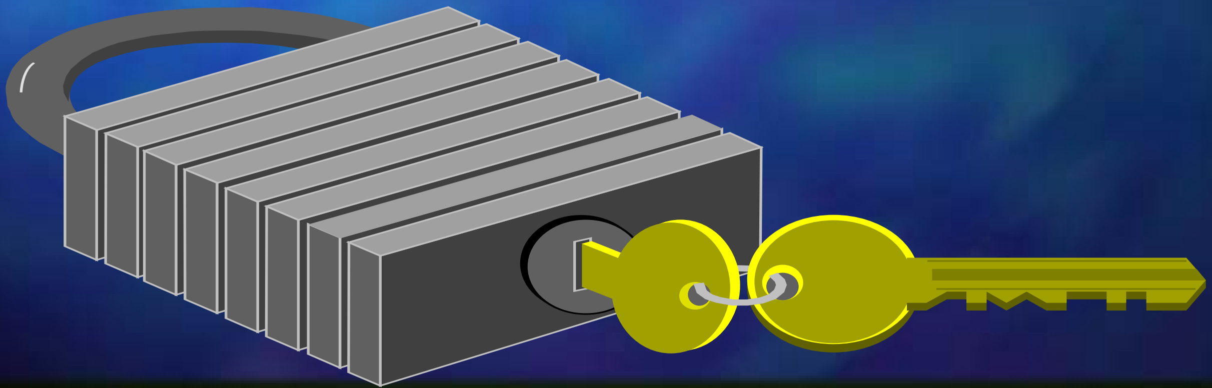
Contractual Safeguards

What kind of safeguards, whether it be provisions or explanations, do you include in your agreements or recommendations, if apprehension and uncertainty exist about changing conditions that may significantly impact the validity of the recommended or agreed upon rates?



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Contractual Safeguards

Concerning agreements, FAR 41.1701 mandates that the terms for expiration and applicability is specified, as well as provisions for cancellation at the behest of either party. Additionally, a provision must be included requiring the contractor to notify both the ACO and auditor of any significant changes in the cost or pricing data. For either FPRAs or FPRRs, the ACO also may recommend the use of re-opener clauses as a provision under future contracts in order to protect the government from subsidizing windfall profits or making overpayments, if the uncertainties are so great. Additionally, language may be included as to the terms and/or applicability of its appropriate usage. Additionally, the attached PNMs should identify and explain all known uncertainties and their potential significance on the rates. This information is useful so as to alert negotiators to changed conditions invalidating any underlying assumptions, as well as to prepare them to counter negotiation points with effective rebuttals in order to sustain the recommended rates. Also, in the case of the latter, it makes it more difficult to deviate from them, without good reason.

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Monitoring

For monitoring purposes, how often do you require contractors to submit tracking reports, and at what level of detail? What factors do you consider in making this determination? Who reviews and analyzes the reports on behalf of the government? Do you make certain that the resulting variance analyses are documented? Do period costs often explain the variances? How do you analyze period costs? What can you do, if variance analysis does not support the rate agreement, either in part or in full?

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Monitoring

Tracking reports should be required as often as you deem necessary to protect the government's interests, whether it be monthly, quarterly, or greater. Considerations should include the dollars at risk, as well as the volatility of the assumptions and uncertainties concerning the business climate. Likewise, a risk assessment and a review of past experience should dictate the depth of detail required. However, be aware that if the frequency for requiring the data is too great between submissions, it may take a good portion of the year, if not most, before an agreement can be cancelled, should that be determined appropriate.

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Monitoring

Also, routinely requiring very detailed data can become very cumbersome, costly, and superfluous. Therefore, the level of detail should be dictated by the degree of visibility required to analyze incurred costs to date versus projections of where you anticipated they would be. Thus, should you determine that top level data is customarily sufficient for this purpose, provisions may be included in FPRAs to give the ACO the right to request more detailed data, as is deemed necessary.

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Monitoring

Normally either the ACO and/or price analyst reviews the data and performs a variance analysis. Regardless of responsibility for this function, it is recommended that a written variance analysis be made part of the file to evidence that One Book, Chapter 6.2 requirements have been met. If variance analysis reveals that the costs are out of tolerance by more than 3% and $100,000, corrective action should be taken such as canceling the agreement or those portions affected, unless the variance is within the projected periodic swing. If not, issuance of a Notice to Disallow Costs may be deemed an appropriate reaction.

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Monitoring

Period costs are recurring costs accrued at a specific time (s) within the accounting year, such as with the annual payment of certain types of taxes. Accordingly, recordation of accrued period costs can significantly distort actuals when viewed on a monthly basis, and thus is one of many possible explanations for monthly tracking reports not manifesting a straight line or linear progression. Accordingly, to help evaluate whether a contractor is where he should be at any given time, a comparison to the same month in the previous year(s) may be used.

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Questioning Costs

Should you wait for receipt of the final rate claim before addressing the allowability of any identified questionable costs? If you choose not to, what is the impact on fixed priced contracts? What are the advantages of issuing a Notice of Intent to Disallow Costs germane to costs in contention?

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Questioning Costs

The best time to question costs is immediately upon discovery in order to mitigate the impact and to avoid discussions of estoppel. Further, in fixed priced situations, unless we can tie the Cost Accounting Standards or Defective Pricing and/or fraud to the issue, we will probably be unable to recoup the costs retroactively. Accordingly, where the issue is contentious, it is probably best to issue a Notice of Intent to Disallow Costs immediately, in order to squash any claims of estoppel.

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Continuous FPRAs

What is a continuous FPRA? What is the obvious advantage? Could you establish one where the base is changing dramatically, or where the product lines are shifting, or where there is to be a restructure and/or merger?

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Continuous FPRAs

A continuous FPRA is one, as the name implies, that allows for continuous update, where the basic assumptions and methodologies are agreed upon so as to accommodate for adjustments as required, including shifts in production or marked changes in the business base. However, where the assumptions are no longer valid, cancellation may be the only reasonable alternative. The key advantage is that continuous coverage is more certain, even as conditions change causing material variances in the rates, while not invalidating the pricing methodologies themselves. However, establishing such an agreement is costly in terms of commitment of resources up front to address the myriad of variables. Also, the effort is invalidated by momentous changes such as restructures in that they may shift the entire pricing paradigm.

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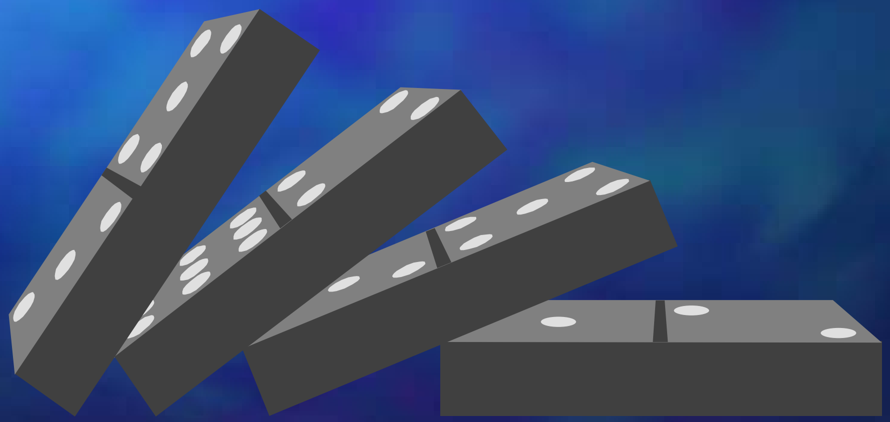
Accounting Periods

How many years do you typically address in an FPRA?



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Accounting Periods

Typically only the current year and two outlying years are included in FPRAs. However, where the PCO is contemplating a five-year contract, there may be a need to include additional years. The needs of your customers should dictate the number of years addressed. In such instances, be aware that the assumptions and pricing models for each succeeding year are less reliable and, therefore, more risky than that for the prior year. Also, you are cautioned that many contractors will attempt to shift projected costs between years in order to cause the government absorb a disproportionate share of those costs. In such cases, contractors will use negotiation ploys such as feigning the concession of costs in years of low government participation in order to finesse ACO acceptance of the contractor's position for years of higher government participation.

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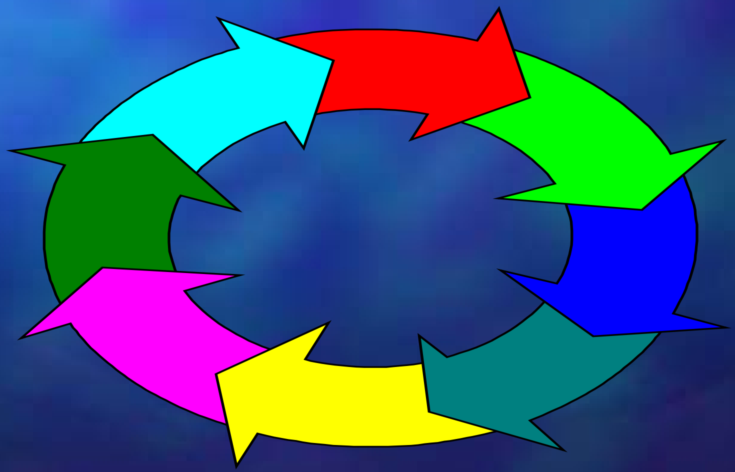
Billing Rates

True or false, do forward pricing rates form the basis for establishing billing rates related to vouchers and progress payments?



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Billing Rates

True, in that FAR 42.704 (b) states that the Contracting Officer should "ensure that the billing rates are as close as possible to the final indirect cost rates anticipated, as adjusted for any unallowable costs."   Also, as was previously stated, the best way to encourage a contractor to submit an adequate forward pricing proposal is to impact his cash flow by decrementing the billing rates to address uncertainties and inadequacies so as to protect the government's interests by precluding premature payments under vouchers and progress billings.

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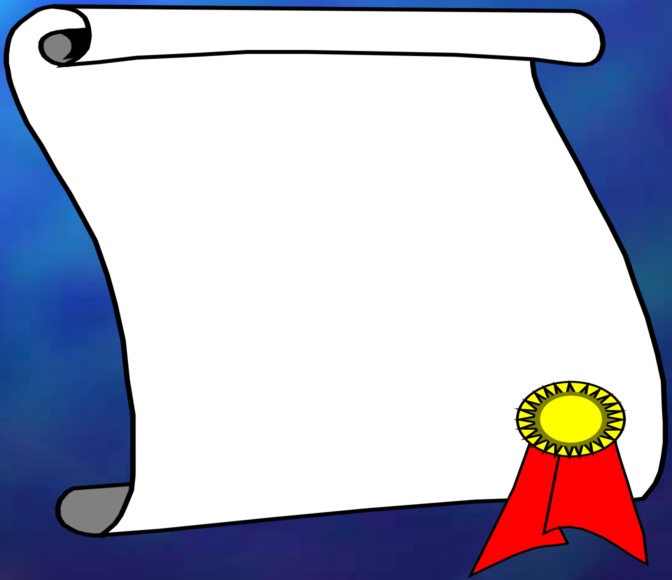
TINA

Does the cost and pricing data need to be certified under the Truth in Negotiations Act (TINA)?



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TINA

Yes, but only as part of individual pricing proposals subject to certified cost and pricing data, but not with the Forward Pricing Rate Proposal itself, pursuant to FAR 15.4073 ©.

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The Business Base

Rule of Thumb: where the business base increases, the rates go down; where the business base decreases, the rates go up. In the case of the former, what are some of the common reasons contractors give as to why their special circumstances will not translate into lower rates? In the case of the latter, what do contractors traditionally do to contain rates in order to remain competitive?

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The Business Base

Reasons contractors commonly give why the rates won't go down:

- Increased capital investment to modernize.
- Increased capital investment to handle the need for increased capacity.
- Increased fixed expenses to accommodate the increased capacity.
- Increased supervision to better control quality and processes.
- Increased IR&D to develop a new generation of systems.
- Increased staffing to meet overly stringent government requirements.

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The Business Base

Common controls contractors put into place:

- Reorganize.
- Lay off workers.
- Streamline or eliminate redundant layers of personnel and processes.
- Acquire new product lines or business bases through buy-outs and/or mergers.

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THE END